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SUBJECT: CHINESE BUSINESSMAN ON CIC IN THE U.S., HONG KONG  
DOLLAR PEG, RUSSIAN INVESTORS, AND PRIVATE EQUITY

Classified By: Economic Minister-Counselor Robert Luke; Reasons 1.4 (b and d)

11. (C) Summary. The China Investment Corporation (CIC), China's sovereign wealth fund, remains interested in pursuing additional investments in the U.S., although not in the financial sector, according to Charles Liu, a well-connected Chinese private equity firm manager in Beijing. CIC Chairman Lou Jiwei, who will visit Washington February 17-20, and some senior Chinese officials remain troubled by CIC's unsuccessful 2008 attempt to purchase a 49 percent share of the U.S. bank Morgan Stanley and believe then-New York Fed President Tim Geithner may have prevented that purchase. Liu also claims that high-level Hong Kong officials are considering shifting the Hong Kong dollar's peg from the USD to a "greater China"-centered basket of currencies, possibly with a 40% weight for the RMB, but China's State Council is reluctant to approve such a change out of concern it would be viewed as a "slap in the face" to the new U.S. administration, and also could precipitate a decline in the U.S. dollar. Liu said Russian investors currently are exploring various large investments in China, in part due to deterioration of the Russian economy. The Chinese Government is taking a cautious approach to development of the private equity sector, but remains committed to developing private equity as an alternative to bank lending and a way to improve corporate governance. End Summary.

12. (C) On February 6, 2009, Financial Minister-Counselor and Econ Officer met with Charles Yang-Sheng Liu, the founder and manager of Hao Capital, a Chinese private equity firm that invests in companies in China. Liu claimed his firm manages approximately USD 700 million in assets. He previously worked as a senior advisor to various large international corporations and was managing director of Lazard Asia Ltd. from 1993-99. From 1975-90, Liu was employed in various capacities in the United Nations system. He was born in Taiwan, moved to the U.S. at age 10, and attended Princeton (B.A.) and NYU School of Law. In 1975, he relinquished his Taiwan passport and U.S. permanent residency to become a citizen of the PRC.

China Investment Corporation  
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13. (C) Commenting on CIC's inner workings, Liu said CIC Chairman Lou tends to focus more on relations with the PRC State Council, while CIC President Gao is more active in structuring deals. Last year, however, Lou was interested in arranging the purchase through a consortium of a 49 percent share of the U.S. bank Morgan Stanley (MS). Hao said the impression now in Chinese financial circles is that the deal was nixed by then-President of the New York Federal Reserve Bank Tim Geithner. According to Liu, there are reports among Chinese officials that Geithner reportedly said that having

"funny money" own 49 percent of MS was not acceptable. Lou and CIC still want to use CIC investments as a way to promote good U.S.-China relations, and his trip to the United States is to help CIC decide both the country and sectoral allocations of CIC assets. Lou is very cautious about further investments in the U.S. financial sector, due to CIC's heavy losses on previous investments (and Chinese public criticism of those losses), as well as what he regards as the hostile regulatory environment to Chinese investment in that sector. During his upcoming U.S. visit, Lou will travel to New York to explore additional CIC placements in third party funds, particularly mutual funds.

#### Hong Kong: Dropping the USD Peg?

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14. (C) Liu said high-level Hong Kong officials, including from the Hong Kong Monetary Authority, in consultation with mainland officials, are considering shifting the Hong Kong dollar's current peg from the USD to a "greater China"-centered basket of currencies, possibly with a 40 percent weight for the RMB. He said Hong Kong officials are reconsidering the merits of tying their monetary policy to the Federal Reserve; they are struggling with the effects of the global economic downturn, while also trying to contain excessive growth in liquidity as risk-averse investors are pulling their funds from other Asian emerging markets, such as South Korea, and placing them in Hong Kong. According to Liu, however, China's State Council is reluctant to approve any change in Hong Kong's exchange rate system out of concern it would be viewed as a "slap in the face" to the new U.S. administration and could precipitate a decline in the U.S. dollar. China's senior leaders want to assess President

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Obama's China policies and actions before taking any actions that could be viewed as undermining the U.S. If the U.S. adopts trade protectionist policies or other anti-China measures, however, the Chinese Government would have numerous tools for response, according to Liu.

#### Russians Want to Invest in China

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15. (C) Liu said that as the Russian economy deteriorates, Russian investors currently are exploring various large investments in China. For example, one group recently offered to buy a 51 percent share in a Chinese steel mill, but were told China does not allow foreigners to hold majority stakes in steel producers. Now, the Russians want to buy 49 percent. Liu described these and other Russian investors as "very scary, because they're all KGB."

#### Private Equity: China Cautious

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16. (C) Liu said the Chinese Government is taking a cautious approach to development of the private equity sector, as it believes the first wave of foreign private equity investment firms in China were not successful. This in part was because they relied upon foreign and/or young overseas-educated Chinese staff to manage their operations in China; neither group understood the Chinese market well. Nevertheless, the government is committed to developing private equity as an alternative to bank lending and a way to improve corporate governance (through large commercially-oriented strategic investors). The large state-owned private equity firms established to date have been set up primarily to fund specific projects: in Guangdong Province for the nuclear power industry, in Sichuan for electronics, etc. For each firm, approximately 80 percent of its funding is for use in the specified projects, while the remaining 20 percent is for "dabbling" in other investments. Liu said two provincial funds have out-sourced asset management to his firm.

17. (C) Liu said that weakness of the Chinese stock markets has essentially stopped IPOs, an important vehicle for private equity firms to exit out of these investments. However, the decline in share prices has also reduced the

cost of "back door listings" in which his company has actively bought "shells" (low-priced listed companies with few assets) in Shanghai. He injects new assets into the shells, then issues more shares. Getting regulatory approval for the issuance of new shares, as opposed to IPOs, is much easier and these "back door listings" have proven to be highly profitable.

18. (C) Finally, Liu said there has recently been a notable increase in demand for Qualified Foreign Institutional Investor (QFII) quotas, with some investors now again willing to pay a premium. This is because U.S. and other foreign investors have become increasingly concerned about the market impact of large-scale issuance of government debt and see RMB-denominated investments, given their expectations of likely RMB appreciation over the long-term, as a means of preserving capital.

19. (C) Comment: Although this was our first meeting with him, Liu appeared highly knowledgeable on a broad range of financial issues in both the U.S. and China, and frequently referred to business and/or personal relationships with prominent Chinese and foreign people. The primary purpose of our meeting with Liu, held at his request, was to discuss the scheduled February 17-20 visit to the U.S. of China Investment Corporation (CIC) Chairman and CEO Lou Jiwei. Hao said he has been advising Lou "on a personal basis for ages" and said he wanted to meet with us prior to his scheduled meeting with Lou. With Lou scheduled to meet Secretary Geithner and other senior USG officials in Washington February 18-20, his comments regarding Chinese perceptions of Secretary Geithner's alleged role in the proposed CIC investment of Morgan Stanley are interesting.  
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